Zacks Small-Cap Research

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University General Health System, Inc. (UGHS –OTC)

UGHS: Awaiting earnings report and update on South Hampton Community Hospital acquisition.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	08/26/2012
Current Price (03/08/13)	$0.60
Six- Month Target Price	**$0.90**

OUTLOOK

University General Health System is a multi-specialty health care provider that owns and operates a regional healthcare network comprised of a core hospital and several complementary healthcare facilities in the metropolitan Houston market. In December, the company acquired a second core hospital in the Dallas market, which should serve as the anchor to an additional healthcare network in the Dallas-Fort Worth market. University General is expected to report year-end results soon. We reaffirm our Outperform rating and price target of $0.90.

SUMMARY DATA

52-Week High	**$0.60**
52-Week Low	**$0.20**
One-Year Return (%)	**160.87**
Beta	**-0.93**
Average Daily Volume (shrs.)	**770,946**
Shares Outstanding (million)	**325.7**
Market Capitalization ($ mil.)	**$195.4**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**2**
Insider Ownership (%)	**46.4**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/M**
P/E using 2012 Estimate	**60.0**
P/E using 2013 Estimate	**15.0**
Zacks Rank	**3**

Risk Level	**Above Average**
Type of Stock	**Small - Growth**
Industry	**Medical Care**
Zacks Rank in Industry	**7 of 17**

ZACKS ESTIMATES

Revenue
(in thousands of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	15.4 A	17.9 A	20.7 A	18.5 A	72.5 A
2012	21.7 A	33.0 A	40.8 A	42.5 E	138.0 E
2013					176.0 E
2014					230.0 E

Earnings per Share
(EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	-$0.00 A	-$0.00 A	$0.00 A	-$0.01 A	-$0.01 A
2012	-$0.00 A	$0.01 A	-$0.00 A	-$0.00 E	-$0.01 E
2013					$0.01 E
2013					$0.04 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

Results originally reported under March FY; results re-arranged as Dec. year.

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KEY POINTS

- University General Health System is a multi-specialty health care provider that owns and operates a general acute care hospital, eight hospital outpatient departments, one ambulatory surgical center and three senior living facilities in the **Houston** market and one general acute care hospital in **Dallas**. The company also owns and utilizes a support services organization that provides billing and other administrative services to health care companies.
- Since March 2011, University General Health System has pursued an aggressive **acquisition strategy**, building an integrated network of ancillary and complementary healthcare services in the Houston area with University General Hospital at its core. Management expects both to continue filling in its **health care network in the Houston market** and is starting to **replicate the process in the Dallas market** with the acquisition of South Hampton Community Hospital.
- Through acquisitions and organic growth, total revenues increased 29.2% in 2011 to $72.5 million. Continuing the trend, total revenues during the first nine months of 2012 advanced 55.9% over the comparable period last year to $84.2 million.
- The acquisitions announced in the second half of 2012 (the three clinics at the Kingwood Diagnostic and Rehabilitation Center, the Robert Horry Center for Sports and Physical Rehabilitation Center and a sleep and imaging center in Baytown) are expected to contribute $12.5 million in incremental revenue and $4.2 million in EBITDA during the first year within the University General system.
- After implementing its plans to improve census and operating efficiency, management expects that South Hampton will contribute an incremental $40 million to University General's consolidated revenue and $15 million to consolidated EBITDA in 2013.
- By delivering **concierge, patient-oriented care**, the University General network provides uniquely competitive health-related services.
- The **physician-centric model** encourages the delivery of patient-oriented services while concurrently generating incremental revenues within the company's network. Moreover, management believes physician-centric model incentivizes doctors to minimize costs, which in turn helps University General to maintain cost controls.
- The acquisition of the revenue cycle management firm Autimus provides scalable billing capabilities for further geographical expansion through acquisition.
- Consult our Initiation Report dated August 27, 2012 for full background information on the company.
- We reiterate our Outperform rating and price target of $0.90.

RECENT NEWS

Acquisitions

On December 21, 2012, University General announced the signing of agreements to acquire an interest in approximately **31 acres of undeveloped land** for the purpose of establishing a medical complex in **Pearland, Texas**. The land site is located approximately 15 miles southeast of the University General Hospital in Houston. Management believes that Pearland, a suburban city in the Houston metropolitan area, can support another regional health care delivery system. Subject to a $20 million financing commitment for the hospital portion of the complex, the projects for the medical complex include a 50-bed general acute care hospital, a 50,000 square-foot medical office building and a 42-unit memory care facility. University General is seeking financing (both debt and equity) for the projects.

On December 4, 2012, University General announced the acquisition of the **South Hampton Community Hospital**, a 111-bed, 270-physician facility located in Dallas, Texas. Of the $30 million purchase price, $28.5 million was financed by the First National Bank through a 4.25% 10-year loan based on a 20 year amortization schedule. Management expects the transaction to add at least $40 million in revenue and $15 million in adjusted EBITDA in calendar 2013, implying only a two year payback on adjusted EBITDA.

Financings

On September 28, 2012, University General closed on a $28.5 million loan for the acquisition of the South Hampton Community Hospital in Dallas. The loan bears an attractive 4.25% per annum interest rate based on a 20-year amortization schedule, though the loan matures in 10 years when the remaining balance will be due or rolled into new amortized loan.

New Auditors

At the direction of the Board of Directors, on December 29, 2012, the accounting firm of Moss, Krusick & Associates was dismissed, and Crowe Horwath LLP was engaged to audit the company's financial statements for the year ending December 31, 2012.

OVERVIEW

Based in Houston, Texas, University General Health System, Inc. (UGHS: OTC) is a health care facilities company. The company's primary business unit is University General Hospital, a general acute care hospital in Houston, which was opened in 2006. Initially, the hospital was owned and operated by a Texas Limited Partnership (University General Hospital, LP) with a Delaware Limited Partnership (University Hospital Systems, LLP) acting as the general partner. After building out the Houston-based system through the acquisition of several healthcare facilities, management purchased a core hospital in the Dallas market where the development of another healthcare system is planned. University General Health System, Inc. became a publicly-traded company in March 2011 through a reverse merger with Seabridge Freight Corp. whereby the former partners (approximately 90 physicians) received approximately 100 million shares of stock.

Strategic Growth Plan

Long-term, management's strategic growth plan entails the creation and operation of regional health care networks developed around general acute-care host hospitals in other metropolitan areas, replicating the process employed in Houston. Each network is anticipated to be built through the acquisition of a host hospital and ancillary healthcare facilities within a radius such that they can operate under the hospital's licenses as Hospital Outpatient Departments (HOPDs). Each locally concentrated system is expected to consist of a core hospital with free-standing HOPDs (such as procedure facilities, diagnostic imaging centers, physical therapy clinics, among others) and Ambulatory Surgical Centers (ASCs). By consolidating providers into HOPDs, the University General network benefits from higher reimbursement rates. In addition, the company's physician-centric model allows the network to capture incremental revenues for procedures referred within the system.

The Implementation of the Acquisition Strategy in Houston

After completing the reverse merger in March 2011, management embarked on an **aggressive acquisition campaign** designed to create a regional health care network around a core hospital (University General Hospital) **in the Houston area**. During 2011, the company acquired three senior living facilities (**Trinity**), a support services organization that provides billing and other administrative services (**Autimis**) and a luxury hospitality service provider and facility management company (**Sybaris**). As a result, two new business segments were formed: Senior Living and Support Services. In addition, the company acquired 51% of the support services company that manages the six senior living facilities (**TrinityCare**) and 15% of Mainland Surgery Center.

Thus far in 2012, University General has announced five acquisitions: **Baytown Endoscopy Center, 1960 Digital Imaging** (a diagnostic imaging and physical therapy center), **three clinics** (diagnostic imaging, physical therapy and sleep) located at the Kingwood Diagnostic and Rehabilitation Center, the

Robert Horry Center for Sports and Physical Rehabilitation Center and **a sleep and imaging center** located in Baytown. University General Health System is expected to continue acquiring ancillary healthcare facilities in the Houston area in order to help fill out in its health care network, including free-standing emergency rooms, ambulatory surgical centers, diagnostic imaging centers, physician practices, post-acute skilled nursing facilities (SNFs) and other complementary facilities. Also, it is possible that additional host hospitals may be acquired.

Timeline

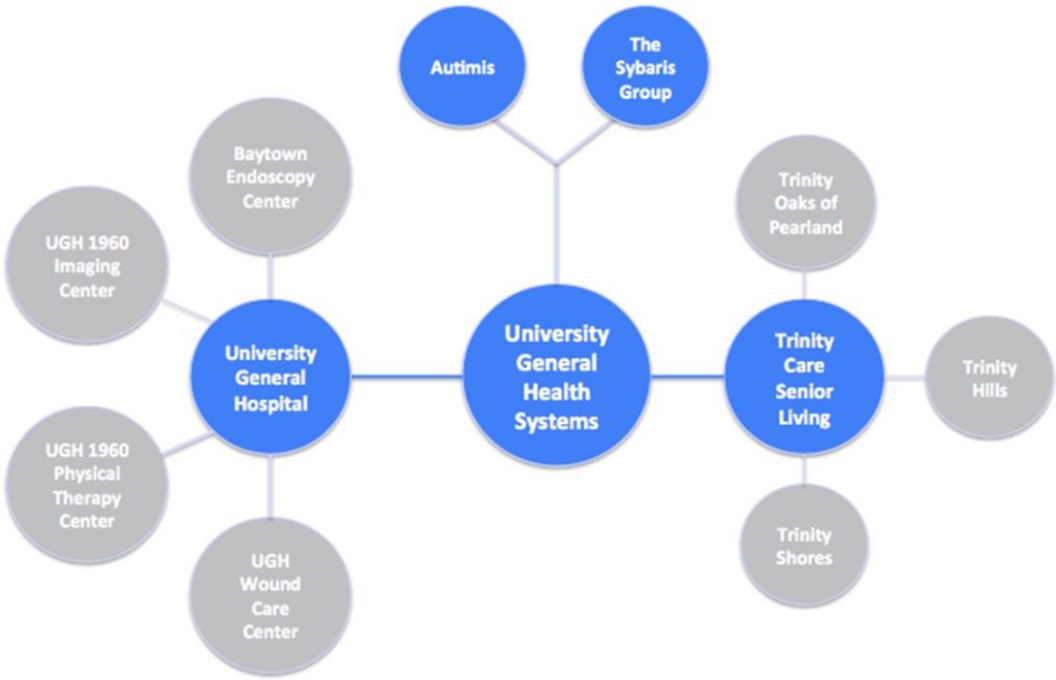
• August 2005	University General Hospital LP founded
• September 27, 2006	University General Hospital opens
• May 2010	Opened hyberbaric wound care center as HOPD
• March 28, 2011	UGHS becomes public company in reverse merger with SeaBridge Freight
• April 25, 2011	Opened Kingwood Neighborhood Emergency Center as HOPD
• May 1, 2011	Acquired 15% of Mainland Surgery Center as ASC
• June 30, 2011	Acquired Trinity Oaks, Trinity Shores and Trinity Hills senior care facilities
• June 30, 2011	Acquired 51% of TrinityCare Senior Living, LLC
• June 30, 2011	Acquired Autimis, LLC and Autimis Medical Billing, LLC
• December 31, 2011	Acquired The Sybaris Group, LLC
• February 10, 2012	Kingwood Neighborhood Emergency Center exits UGHS network
• April 13, 2012	Acquired Baytown Endoscopy Center as HOPD
• June 1, 2012	Acquired 1960 Digital Imaging (now UGH Diagnostic Imaging) as HOPD
• August 1, 2012	Acquired three clinics at the Kingwood Diagnostic and Rehabilitation Center
• August 27, 2012	Acquired Robert Horry Center for Sports and Physical Rehabilitation Center
• October 30,2012	Acquired a sleep and imaging center in Baytown as HOPD
• December 31, 2012	Acquired South Hampton Community Hospital in Dallas

University General Health System operates **three business units**: Hospital, Senior Living and Support Services.

- ***Hospital*** (94.2% of revenues in 2011) Located in Houston, the Hospital unit is comprised of a 69-bed general acute care hospital, the company's corporate offices and several Hospital Outpatient Departments (HOPDs), including a hyberbaric wound care center, UGH Diagnostic Imaging, UGH Physical Therapy, Baytown Endoscopy Center, three clinics at Kingwood Diagnostic and Rehabilitation Center, the Robert Horry Center for Sports and Physical Rehabilitation Center, a sleep and imaging center in Baytown and an Ambulatory Surgical Center (ASC) known as Mainland Surgery Center.
- ***Senior Living*** (4.9%) Owning three senior living communities in Texas (Trinity Oaks in Pearland, Trinity Shores in Port Lavaca and Trinity Hills in Knoxville), the Senior Living unit offers housing and assistance to elderly and mid-acuity frail residents. All three senior living facilities were acquired in June 2011. Also, University General purchased a 51% controlling interest in Trinity Care Senior Living, the support services company that manages the facilities. In total, UGHS operates six senior living facilities.
- ***Support Services and Other*** (0.8%) Composed of the Autimus and Sybaris acquisitions, Support Services provides revenue management, food, hospitality and facility services to University General Hospital and other healthcare companies. Acquired in June 2012, Autimus provides billing and coding services while Sybaris, which was acquired in December 2012, offers food, hospitality and facility management services.

HOSPITAL FACILITIES SEGMENT (HOUSTON)

The Hospital segment of University General Health System is composed of a regional health care network serving the Houston market, which consists of an acute-care hospital (University General Hospital), an ambulatory surgical center (Mainland Surgery Center) and several HOPDs (see below). The Hospital segment represented **91.1% of UGHS's revenues** during the first nine months of 2012.



University General Hospital, the company's initial healthcare facility, opened on September 27, 2006. Located at 7501 Fannin Street in Houston, the facility is a 69-bed general acute-care hospital with six intensive care unit beds and 11 intermediate care unit beds. The hospital provides a wide range of patient care, including 24-7 emergency services, inpatient surgery, outpatient surgery, heart catheterization procedures, pain management, physical therapy, sleep study, diagnostic imaging and respiratory therapy, among others. Also, University General Hospital offers concierge care, delivering amenities that a patient would have at home or at an upscale hotel. Some of these amenities include private rooms with hardwood floors, flat screen televisions, internet access and meals served on china.

Hospital Outpatient Departments

Integral parts of University General's regional health care network are the company's Hospital Outpatient Departments (HOPDs), namely:

- University General Hospital - Baytown Endoscopy Center
- University General Hospital - Hyberbaric Wound Care Center located at the hospital
- UGH Diagnostic Imaging and UGH Physical Therapy (previously known as 1960 Digital Imaging)
- KW Physical Therapy, UGH KW Imaging and UGH KW Sleep Center operating in the Kingwood Diagnostic and Rehabilitation Center
- UGH Robert Horry Center for Sports and Physical Rehabilitation Center
- A sleep and imaging center located in Baytown

An important aspect of University General's **accretive acquisition model** is the pricing benefit inherent to the migration a medical clinic from the status of an ASC to a HOPD. Procedures performed at hospitals and HOPDs are under a higher reimbursement payment structure for various reasons. For

example, hospitals are held to more rigorous standards of safety and quality of care, in addition to having higher overhead costs. Therefore, hospital reimbursement rates by third-party payors and Medicare and Medicaid are generally 30% to 75% higher. Legally, a hospital can only pay "fair market value" for a physician's interest in an ASC, and according to the definition by the IRS, the assessment of fair market value may not consider an anticipated higher payment structure. Given the disparity in reimbursement rates and the transaction valuation of HOPDs and ASCs, it is attractive for hospitals to acquire clinics and ASCs at fair market value. For the physician owners of the clinics, the benefits of joining an integrated delivery model far exceed the reduction of a portion of the autonomy of an independent practice. Also, under the umbrella of a hospital network, both University General and the physicians of the acquired clinics benefit from greater, hospital-based reimbursement rates by third-party payors and Medicare and Medicaid under the HOPD payment system.

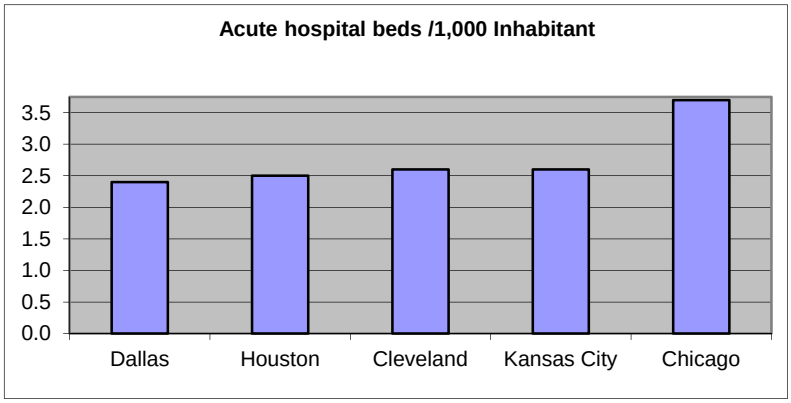
DALLAS HEALTHCARE MARKET

With the recent acquisition of South Hampton Community Hospital, University General entered the Dallas healthcare market. Management believes there are substantial growth opportunities in the Dallas-Fort Worth (DFW) market, which is experiencing rapid population growth and lags the nation in terms of per capita hospital bed capacity. The state of Texas, in general, remains below the national average in terms of hospital beds per capita (2.43 beds versus roughly 2.85 nationally).

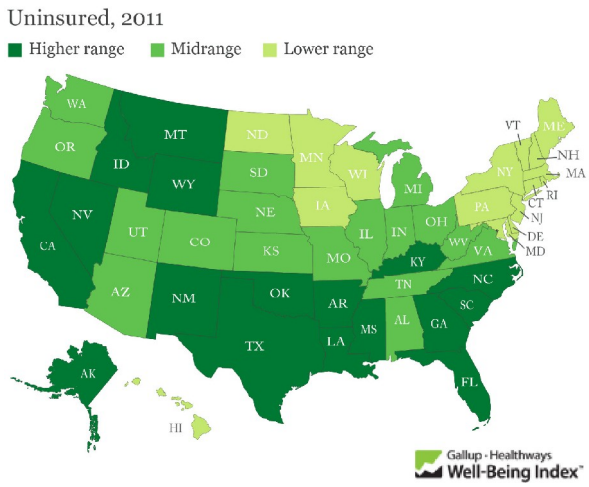
Beds per 1,000 Persons by State, 2009 and 2010

State	Beds / 1,000 Persons		State	Beds / 1,000 Persons	
	2009	2010		2009	2010
Alabama	3.25	3.19	Montana	3.92	3.77
Alaska	2.19	2.18	Nebraska	4.14	4.00
Arizona	2.04	2.00	Nevada	1.94	1.96
Arkansas	3.31	3.25	New Hampshire	2.16	2.15
California	1.86	1.89	New Jersey	2.42	2.42
Colorado	2.06	2.00	New Mexico	1.95	1.95
Connecticut	2.26	2.29	New York	3.09	3.04
Delaware	2.40	2.42	North Carolina	2.43	2.43
District of Columbia	5.76	5.66	North Dakota	5.20	5.12
Florida	2.87	2.85	Ohio	2.95	2.98
Georgia	2.59	2.57	Oklahoma	3.07	3.00
Hawaii	2.29	2.42	Oregon	1.69	1.67
Idaho	2.19	2.16	Pennsylvania	3.11	3.16
Illinois	2.62	2.57	Rhode Island	2.39	2.35
Indiana	2.69	2.76	South Carolina	2.74	2.72
Iowa	3.42	3.33	South Dakota	5.10	5.01
Kansas	3.59	3.51	Tennessee	3.33	3.29
Kentucky	3.27	3.28	Texas	2.50	2.43
Louisiana	3.53	3.40	Utah	1.79	1.80
Maine	2.72	2.72	Vermont	2.08	2.07
Maryland	2.09	2.04	Virginia	2.22	2.23
Massachusetts	2.35	2.37	Washington	1.70	1.71
Michigan	2.59	2.58	West Virginia	4.07	4.00
Minnesota	2.96	2.90	Wisconsin	2.41	2.39
Mississippi	4.36	4.37	Wyoming	3.68	3.58
Missouri	3.19	3.12			

Moreover, the per capita bed capacity in the Dallas-Fort Worth region is lower than the state average with DFW being home to approximately 25% of the state's population but only having about 22% of the state's hospital beds (American Hospital Association). And, according to the Dartmouth Atlas of Health Care, Dallas has only 2.4 acute hospital beds per 1,000 persons compared to 2.5 for Houston.



In general, Texas has one of the nation's highest levels of uninsured inhabitants (see figure below). An estimated 27.6% of the population was uninsured in 2011, according to the Gallup Healthways Well-Being Index. Similar to the state overall, the level of uninsured people in the Dallas market exceeds the national average, at about 24% compared to the national average of roughly 16%. In fact, two of the top 20 hospitals reporting the highest uncompensated care in 2011 were located in Dallas.



Texas Acute Care Hospitals
Reporting the Highest Uncompensated Care, 2011

Facility	City	County	Ownership	Total Uncompensated Care ($M)	Total Gross Patient Revenue ($M)	Uncompensated Care as a Percentage of Gross Patient Revenue
Parkland Memorial Hospital	Dallas	Dallas	Public	$1,532	$3,415	44.9%
Harris County Hospital District Ben Taub Gen'l	Houston	Harris	Public	$1,427	$2,432	58.7%
Baptist Medical Center	San Antonio	Bexar	For Profit	$945	$3,747	25.2%
John Peter Smith Hospital	Fort Worth	Tarrant	Public	$931	$1,854	50.2%
University Medical Center at Brackenridge	Austin	Travis	Non-Profit	$431	$1,386	31.1%
University Hospital	San Antonio	Bexar	Public	$357	$1,315	27.1%
University Medical Center of El Paso	El Paso	El Paso	Public	$306	$739	41.4%
Scott and White Memorial Hospital	Temple	Bell	Non-Profit	$287	$2,436	11.8%
Mother Frances Hospital	Tyler	Smith	Non-Profit	$279	$2,212	12.6%
University Medical Center	Lubbock	Lubbock	Public	$242	$1,323	18.3%
The Methodist Hospital	Houston	Harris	Non-Profit	$238	$4,093	5.8%
Edinburg Regional Medical Center	Edinburg	Hidalgo	For Profit	$226	$1,980	11.4%
University of TX M.D. Anderson Cancer Center	Houston	Harris	Public	$224	$5,544	4.0%
Methodist Hospital	San Antonio	Bexar	For Profit	$212	$4,903	4.3%
Memorial Hermann Hospital	Houston	Harris	Non-Profit	$207	$2,890	7.2%
East Texas Medical Center	Tyler	Smith	Non-Profit	$201	$2,318	8.7%
Baylor University Medical Center	Dallas	Dallas	Non-Profit	$201	$2,335	8.6%
CHRISTUS Spohn Hospital Corpus Christi	Corpus Christi	Nueces	Non-Profit	$198	$2,527	7.8%
Covenant Medical Center	Lubbock	Lubbock	Non-Profit	$190	$2,697	7.1%
Good Shepherd Medical Center	Longview	Gregg	Non-Profit	$177	$1,216	14.6%
Total				**$8,812**	**$51,362**	**17.2%**
State Total				**$18,082**	**$191,021**	**9.5%**

Source: Texas Department of State Health Services

Although the high level of uncompensated care in the DFW are might have some impact University General's uncompensated costs over time, we believe the risk is mitigated by University General's focus

on providing concierge medical services in an upscale setting and the company's lower than industry average exposure to Medicare / Medicaid reimbursements.

The Dallas market should be able to support additional hospital and healthcare networks, especially since the population is increasing and aging. The expected increased demand for healthcare services in DFW is reflected by many hospital expansion plans recently completed or planned. HCA, Texas Health Resources, Methodist Health System, Cook Children's Health Care System of Fort Worth and Children's Medical Center, have all either announced or recently completed new or expansion projects. Recently completed projects include a $92 million hospital in the Alliance area (located north of Fort Worth) by Texas Health Resources, a $205 million expansion in McKinney (on the northeast edge of DFW) by Baylor, a $60 million surgery hospital in Addison (a northern suburb of Dallas) by Methodist Health and an $80 million hospital in Frisco (due north of Dallas) by Forest Park. Also, Baylor University Medical Center, a not-for-profit hospital in Dallas, has completed a $125 million renovation project including the opening of the Baylor Cancer Hospital. In addition, Methodist Health is currently building a $120 million hospital in Richardson (northeastern suburb of Dallas).

South Hampton Community Hospital

South Hampton Community Hospital is a 111-bed, 270-physician facility that is operating significantly below its breakeven threshold. South Hampton Community Hospital offers services similar to those at University General Hospital in Houston; the Dallas hospital specializes in orthopedic and cardiac surgery as well as urology, ear-nose-and-throat (ENT), general medicine and bariatrics. The acquisition also includes a 22,000 square foot medical office building, which currently is approximately 55% occupied.

Management hopes to leverage its experience in turning around University General Hospital by replicating the process at South Hampton Community Hospital by pursuing the same strategy in Dallas as in Houston. The hospital will be upgraded with at least $1.0 million in capital improvements in order to enable the capability of providing concierge healthcare services. Importantly, South Hampton Community Hospital will be rebranded as University General Hospital – Dallas. The South Hampton Community Hospital has undergone two bankruptcies in the past decade and, according to University General's management, has "had some challenges, multiple management companies that have failed." Initially, University General will launch safety and quality improvements at the hospital, and over time, plans to improve the occupancy rate at the medical office building.

The acquisition marks University General's entrance into the company's second market and the further execution of management's acquisition strategy with another core hospital. We expect the hospital serve as an anchor hub to several HOPDs (Hospital Out Patient Departments), which will enhance the offering of healthcare services and leverage the cost infrastructure of the Dallas system. Adding facilities as new HOPDs has multiple benefits, including driving incremental revenue growth, achieving economies of scale, boosting average daily inpatient census and often improving the company's overall payer mix. Thus, the acquisition of South Hampton Community Hospital advances the company's acquisition strategy by developing another system of healthcare facilities in a second metropolitan market and operating under the University General brand.

South Hampton generated $11.3 million in net revenue during the first nine months of 2012. After implementing its plans to improve census and operating efficiency, management expects that South Hampton will contribute an incremental $40 million to University General's consolidated revenue and $15 million to consolidated EBITDA in 2013.

SENIOR LIVING SEGMENT

The **Senior Living segment** is comprised of the Trinity assets, which were acquired on June 30, 2011. Due to the Trinity assets being acquired mid-year, year-end segment figures for 2011 are misleading; however, during the first nine months of 2012, the Senior Living segment represented **7.0% of UGHS's revenues**. This business unit derives revenues principally from resident fees, which reflect costs charged for housing, support services and assisted living care. Senior Living residents typically sign resident agreements for one-year renewable terms. The business also generates revenue from entrance fees, community fees and management fees. Despite the difficult economic backdrop, the Senior Living segment recorded an overall occupancy rate above 94.4% in the third quarter ending September 30, 2012. Management has indicated that the TrinityCare concept may be expanded to facilities in Pearland, Texas; Covington, LA; Shreveport, LA; Seymour, TN; Crossville, TN and Cookeville, TN.

University General acquired three senior living communities in an acquisition completed on June 30, 2011 for 23,395,895 shares and certain assumed liabilities. These facilities are: 1) **Trinity Oaks** of Pearland and 2) **Trinity Shores** of Port Lavaca in Texas, and 3) **Trinity Hills** of Knoxville, Tennessee. Trinity Oaks is an 80-unit senior living community, which has been in operation since 2001. Trinity Shores is a 63-unit senior living community that has been in operation since 2007, and Trinity Hills is an 87-unit senior living community that has also been in operation since 2007. Also, University General acquired a 51% stake in **TrinityCare Senior Living**, which develops and manages senior living communities. TrinityCare manages the three Trinity senior living communities acquired by University General, and three additional facilities in Georgia (assisted living community and two memory care greenhouses). Management intends to continue developing new facilities both nationally and potentially internationally.

SUPPORT SERVICES AND OTHER SEGMENT

The **Support Services segment** is primarily composed of The Sybaris Group, Autimis and Autimis Medical Billing, all three having been acquired in 2011. Since Sybaris was acquired on December 31st, year-end segment figures are misleading; however, during the first nine months of 2012, the Support Services segment accounted for **1.9% of UGHS's revenues**.

University General strengthened its back office services capabilities through acquisitions in 2011. **Autimis** and **Autimis Medical Billing** were acquired on June 30, 201. These two companies are focused health care billing, coding and revenue cycle management. Both of the Autimis companies serve the healthcare industry including hospitals, ambulatory surgery centers, laboratories and emergency rooms. Autimis has been providing billing, coding and other revenue management services to University General since September 2009. Autimis will continue to provide these services to University General and generate incremental revenue through service agreements with third party healthcare providers. Autimis results are included in the company's Support Services business segment.

University General acquired **Sybaris Group** on December 31, 2011. Sybaris provides luxury hospitality and facility management services. In addition to providing food, housekeeping, parking valet and information technology services to University General, Sybaris provides these services and others (such as plant operations & maintenance, executive & conference event planning, etc.) to a total of twelve clients in Houston. Sybaris has about 100 employees and generated revenues of about $5.5 million and estimated earnings of $500,000 in 2011. The company financed the Sybaris acquisition with 5.0 million shares of its common stock. The company expects that the addition of Sybaris will enable University General to leverage its concierge concept and operating infrastructure as it expands. For example, recently, the Sybaris Group was selected as the official catering company for the Athletics Department of Rice University. Sybaris is also included in the company's Support Services operating segment.

PHYSICIAN-CENTRIC MODEL

As a result of the acquisitions in the Houston area, University General Health System has developed a health care network with multiple healthcare-related revenue streams and the synergies related to a **physician referral network**. Fostering a physician-centric system, there are approximately 550 physicians with hospital privileges at the University General Hospital, including approximately 90 physicians have an equity interest in UGHS. Obviously, share ownership aligns the interests of the hospital with that of the doctors who feed the hospital with patients through the referral system. In addition, a collaborative culture in the operating rooms, patient floors and ancillary service units encourages physicians without equity ownership to take an active role in hospital operations. In turn, the hospital provides opportunities to benefit from collaborating with UGHS, such as working with large primary care groups to improve their operating performance in their clinics.

CONCIERGE CARE

Concierge medicine has grown significantly since it was first introduced in 1996. According to the AAPP (American Academy of Private Physicians), there are an estimated 3,500 concierge physicians across the nation, up 46% from about 2,400 physicians roughly a year and a half ago. The AAPP also estimates that concierge doctors serve almost a million patients nationwide.

University General Health System strives to provide patient-centric health care not only by promoting the active involvement of patients and their families in the design and delivery of medical treatments, but also by providing quality patient care in a soothing and restful environment with concierge service. Studies have shown that the concierge environment calms the anxiety surrounding most hospital stays.

At University General Hospital, concierge services are delivered at no additional cost to the patient. By providing concierge-level healthcare that is not associated with a fee, University General possesses a competitive advantage over local competing hospitals for elective medical procedures and diagnostic services.

The interior design of University General Hospital, including the patients' rooms, reflects the up-scale ambiance of a luxury hotel. Upon arriving, patients and guests are greeted by a parking attendant and are provided complimentary valet parking. The lobby features a baby grand piano and soothing waterfall. Marble floors enhance public areas. The hospital's interior design creates a comforting environment for the time spent while recovering from an illness or a medical procedure. The rooms are private with hard-wood paneling and are equipped with flat screen televisions. Wireless internet access is complimentary. Meals, which are nutritionally-balanced and designed for high-quality taste and satisfaction, are served on fine china. The ambiance, accoutrements and food service are designed to make one's hospital stay as pleasant as possible.

The Sybaris Group, acquired by UGHS, provides the hospitality and facility management services for University General Hospital. Sybaris supplies the housekeeping and valet parking, in addition to the food and nutrition services. The environmental housekeeping services include the cleaning, disinfecting and/or sanitizing of both public areas and rooms. Since Sybaris is capable of delivering a five-star culinary experience at executive & conference events, the menus at University General Hospital include meals that are well-planned, nutritional, healthy and tasty. Also, staff concierge providers can aid family members in arranging transportation to and from the hospital and with hotel, airline and restaurant reservations. The University General concierge can even assist with ordering flowers, renting cars and providing information on and transportation to local cultural sites and activities. Management believes that by providing concierge healthcare through an environment that brings comfort to patients and families, University General should be the hospital of choice in Houston.

VALUATION

Valuation methodologies for large-cap hospital companies usually entail the use the price-to-revenues, price-to-EBITDA and/or P/E metrics in comparison to the industry mean and median as well as relative to the company's historic valuation range. Though the risks associated with newer, smaller companies, such as University General, are greater than that for more established companies with longer track records, in our view, so are the growth prospects. Therefore, due to University General's size and potential for significant growth, we believe that the large-cap hospital universe is not an appropriate valuation benchmark. Also, University General Health System has not yet established 5-year historic valuation ranges by which the company's industry position, growth profile and financial stability have been assessed by investors.

The industry of Specialty Providers of Hospital-Related Services, however, does appear to be an appropriate valuation benchmark. The significantly higher multiples relative to larger hospital companies reflect the fundamental trend towards HOPDs and the increased utilization of ASCs. In addition, the higher multiples better reflect the growth potential of these smaller companies.

The appropriate valuation methodologies for University General are based on price-to-sales (P/S) and enterprise value-to-EBITDA (EV/EBITDA) due the character of the company's enterprise, namely a small-capitalization company with a revenue profile that should experience rapid growth both through internal growth as the company's hospital network is better utilized and through the execution of management's aggressive acquisition strategy. The growing revenue stream has already manifested itself into positive earnings in the second and third quarters of 2012. Based on historical norms for similar specialty providers of hospital-related services companies, we expect UGHS to trade in an EV/EBITDA valuation range between 10.8 and 5.0, and specifically, our target is based on UGHS attaining the first quartile valuation benchmark of a 9.3 EV-to-EBITDA ratio due to the positive news flow of the successful implementation of management's growth strategies. **Our share price target is $0.90**, in which we utilize annualized EBITDA from operations derived from the most recent quarter's results due to the company's rapid EBITDA growth rate. Interestingly, the large-cap hospital universe is currently trading very tightly around its valuation mean and median (approximately 7.0 EV/EBITDA), which should provide a floor valuation for smaller growth companies related to the large-cap hospital facilities industry.

Industry Comparables	Pr Chg YTD	P/E CFY	EPS Gr 5Yr Est	Price/ Book	Price/ Sales	Price/ CF	EV/ EBITDA
UNIVERSITY GENERAL	51.3	N/M	13.5	N/M	1.9	33.0	11.3
S&P 500	8.3	14.4	10.8	5.8	2.5	12.0	N/A
LARGE CAP HOSPITALS							
Industry Mean	8.1	15.5	13.4	2.1	0.9	8.8	7.0
Industry Median	19.7	14.8	12.0	2.1	0.5	5.5	7.0
COMMUNITY HEALTH SYS.	37.9	11.3	12.3	1.4	0.3	3.7	7.2
HCA HOLDINGS	22.8	11.5	11.9	N/A	0.5	4.8	7.0
HEALTH MGT. ASSC.	21.4	12.9	11.8	2.4	0.4	4.6	6.6
LIFEPOINT HOSPITALS	18.8	14.8	9.0	1.1	0.5	5.5	7.0
TENET HEALTH	28.6	14.7	10.2	3.7	0.5	7.0	7.8
UNIVL HEALTH SVCS.	23.0	13.3	10.4	2.2	0.8	8.1	7.5
VANGUARD HEALTH	20.6	18.7	12.3	3.4	0.2	3.2	6.3
SPECIALTY PROVIDERS							
Industry Mean	-0.8	12.0	12.0	3.1	1.8	11.1	8.7
Industry Median	0.4	13.6	12.3	1.7	1.0	9.7	8.7
AMSURG CORP.	-0.3	13.6	12.3	0.9	1.0	10.2	5.0
MEDNAX INC.	8.0	15.6	13.8	2.1	2.4	15.8	10.4
PSYCHEMEDICS CORP.	9.3	15.1	11.4	5.3	2.5	15.9	10.8
US PHYSICAL THERAPY	-16.9	14.3	13.3	12.0	1.1	12.5	6.6
VCA ANTECH INC.	5.8	15.0	12.0	1.6	1.2	6.6	8.7

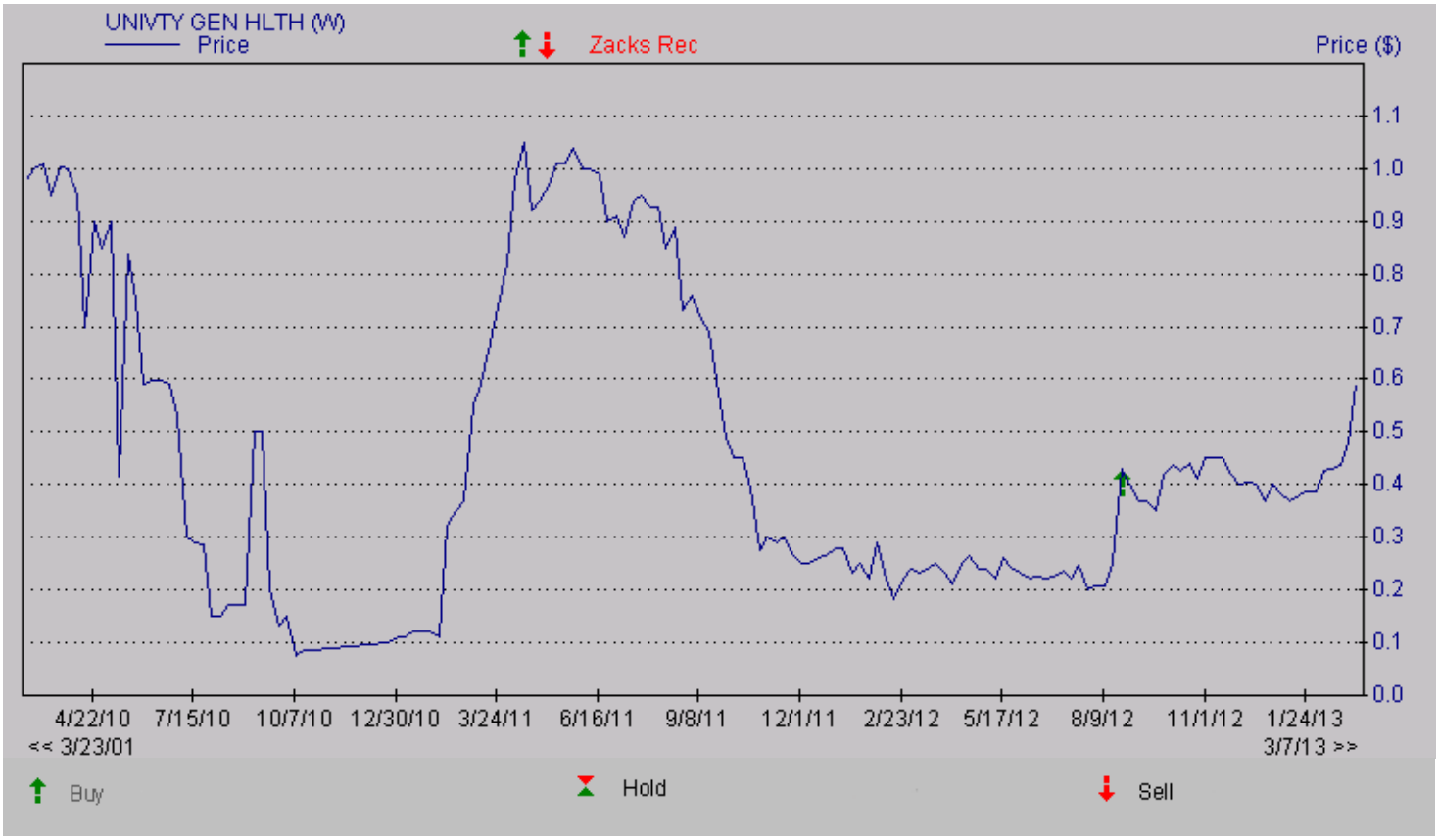
Also, valuation based on the price-to-sales metric confirms and reinforces the $0.90 price target. We expect UGHS to trade in a P/S valuation range between 2.2 and 1.0, which is also based on historical valuations of similar companies. The first quartile valuation benchmark is 2.0 price-to-sales or $0.98 per share utilizing annualized revenues from operations from the most recent quarter's results. Price-to-sales valuation also incorporates a company's ability to increase revenues and gain market share. Given management's stated business plan of becoming a creator, owner and operator of regional health care networks in multiple metropolitan areas, University General is expected to expand its revenue base significantly.

RISKS

- Operating in Texas, one of the states with higher levels of uninsured inhabitants, uncompensated costs could impact the company's profitability over time. However, this risk is partially mitigated by University General's focus on providing concierge medical services in an upscale setting, along with its lower than industry average exposure to Medicare and Medicaid reimbursements.
- CEO Dr. Hassan Chahadeh holds super-voting power through his ownership of 3,000 shares of super-voting Series B preferred stock. Though the preferred stock has no economic value, the voting power is equal to the number of votes of all outstanding shares of capital stock plus one additional vote; therefore, Dr. Chahadeh controls a majority of voting rights on all matters that require shareholder approval. Dr. Chahadeh is a practicing physician himself. Having received a degree in medicine from Damascus University in Syria, Dr. Chahadeh also studied general surgery and anesthesiology at Baylor College of Medicine in Houston. He has been involved with University General Hospital since it's inception as a founder and managing general partner.
- University General has been or is involved in a number of legal disputes; however, all appear under control and adequately reserved. See Initiation Report for details.

- The disparity of reimbursement levels between different classes of surgical health care facilities (hospitals/HOPDs and ASCs) has sparked proposals to revise the Medicare hospital outpatient prospective payment system (OPPS) and the Medicare ambulatory surgical center (ASC) payment system. On average, Medicare pays 56% of the amount to ASCs that is paid to HOPDs for the same medical services. The discrepancy is a major driving force in the conversion of ASCs to HOPDs. While University General's ASCs likely enjoy similar reimbursement rates to its HOPDs, the level of the company's ASC reimbursements could be at risk if CMS decides to disallow conversions for reimbursement parity.
- The IRS filed tax liens against University General Hospital to collect past due payroll taxes. In August 2011, the hospital entered into an installment agreement with the IRS, under which payments were made until March 2012. As of November 14, 2012, the outstanding balance related to past due payroll taxes was $1,008,303. Management anticipates becoming current through cash flow generated by operations. Also, UGHS became profitable in the second quarter of 2012; therefore, in anticipation of the payment of income tax, the company began recording an Income Tax Payable liability on the balance sheet ($6.1 million as of September 30, 2012).
- In the Houston market, University General Hospital competes with the Texas Medical Center, which is comprised of 15 hospitals, four nursing schools and three medical schools making it the largest medical center in the world. Given that this competing facility is continuing to expand, the demand nursing and other support staff could put upward pressure on labor and other costs that could negatively impact University General's profit margins.

HISTORICAL ZACKS RECOMMENDATIONS



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